eastspring investments

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2016 FIXED INCOME OUTLOOK
SURFING THE VALUE WAVE

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MODERATE VALUE AMIDST SPECTRE OF RATE HIKES

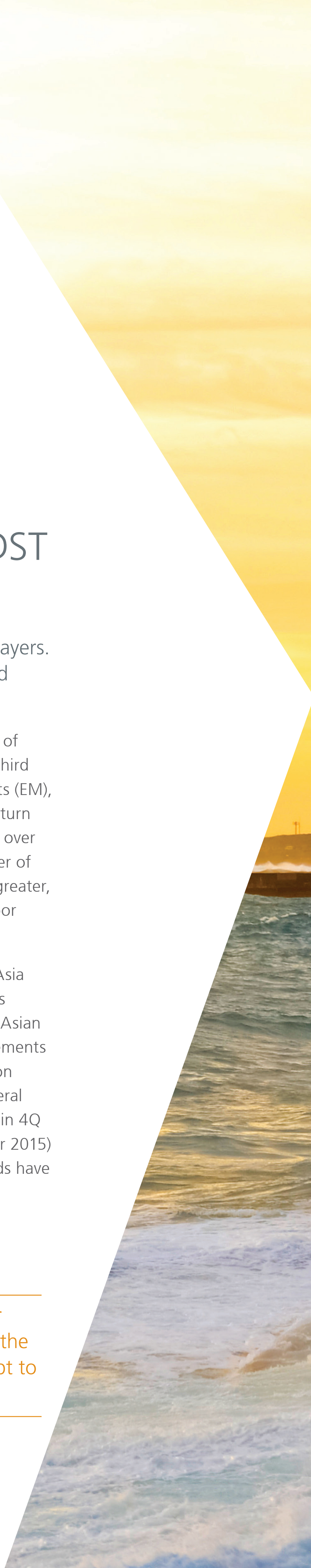
Market outcomes have tended to surprise its players. As it turns out, 2015 was a year of volatility and general pessimism.

Stock markets began on a positive note for the first half of the year, but sentiment took a sharp turnaround in the third quarter on quite sudden concerns over emerging markets (EM), the deceleration in US economic strength and the downturn in commodity prices. Investors were particularly worried over an EM growth crisis, which was exacerbated by a number of China's policy missteps. Worries over Latam were even greater, given the weak commodity price outlook and Brazil's poor fundamentals.

In our 2015 outlook piece, we had recognised that EM Asia growth prospects were delicate, particularly over China's economy, expecting that this would contribute to some Asian market volatility. But the magnitude of the market movements was not anticipated. We also held to a "dovish leaning on global monetary policy". We had expected the first Federal Reserve (Fed) funds rate hike for this cycle to take place in 4Q 2015. This remained at the point of writing (late October 2015) a distinct possibility. For much of 2015, US Treasury yields have stayed broadly range bound, with an easier bias.

US and Euro zone growth recovery appears intact

We now begin the challenge of positioning our investment portfolios for 2016. While we note the prevailing market bearish sentiments, we are apt to take a more optimistic view.

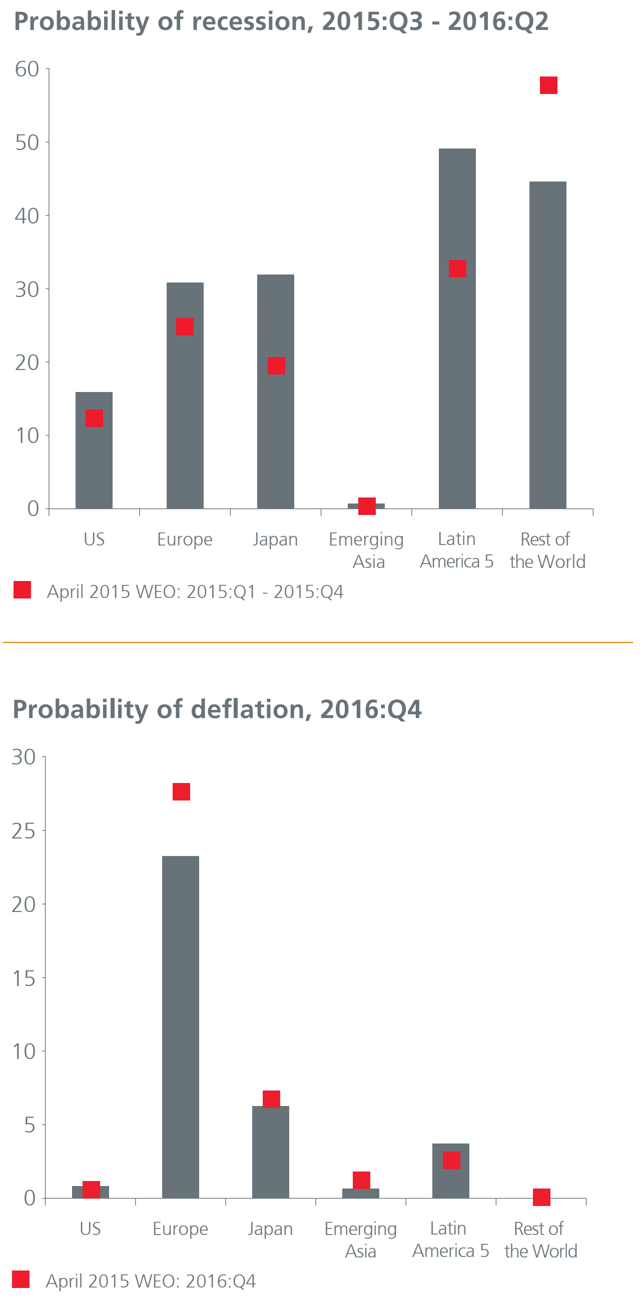


Wave splash within typhoon, Hachijō-jima island, Japan

The trajectory of US and Eurozone growth recovery is intact. The US has been generating close to 200,000 jobs so far in 2015, steadily removing the labour market slack and contributing to the improvements in consumer sentiment and helping the US housing market recovery. Eurozone should also see growth at a fairly healthy clip for 2016, evident in the purchasing manager index readings and strengthening loan growth.

Concerns over EM Asia continue to emanate mainly from China. We anticipate the ongoing stabilisation of China's property market, a moderately expansionary fiscal policy and resilience in consumer spending, enabling the economy to see growth strengthening into 2016. Our confidence in Asia is supported by the International Monetary Fund's (IMF) own analysis. In its October 2015 World Economic Outlook report, the IMF produced its nearer term analysis of recession and deflation risks for various regions. Notably, EM Asia has a much lower probability of experiencing either of these two undesirable outcomes (refer to Fig.2).

Fig.2. IMF World economic – October 2015. Assessment of recession and deflation risk



Source IMF Staff estimates, World Economic Outlook (WEO) Report October 2015.

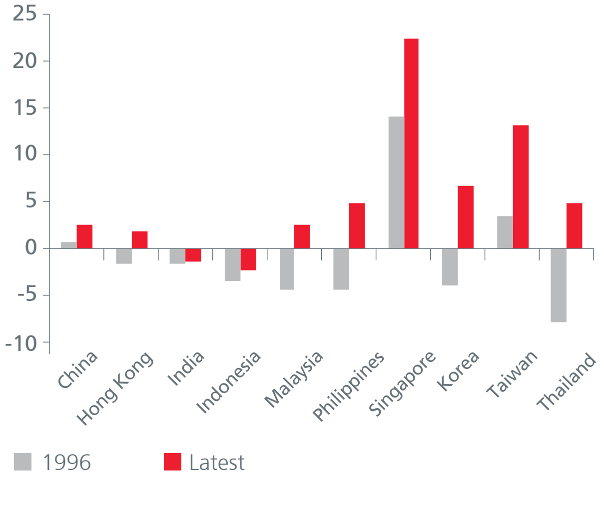
EM Asia backed by positive fundamentals

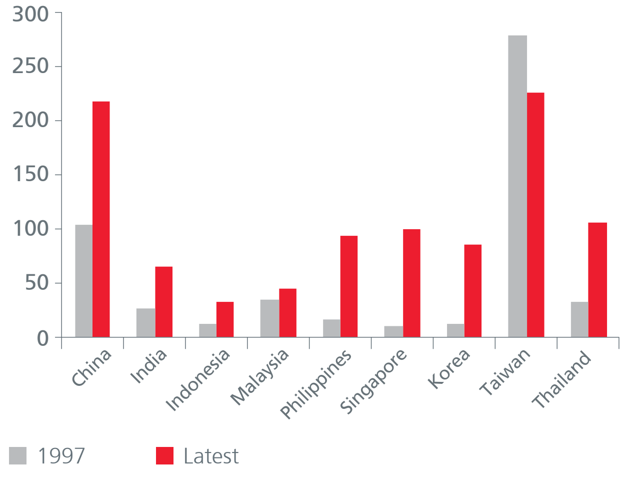
What has been ailing the global capital and, particularly the EM markets has been the weak oil and commodity price outlook. Another significant factor has been the considerable build-up in debt globally. Depressed energy prices, we feel cannot be sustained for an extended period, as the cheap levels should invigorate consumption and reduce production levels. If our expectations about a global recovery come to pass, we should see global growth strengthening further and commodity prices seeing a decided turnaround. This could usher in a six to 12 month recovery period for EM Asia's bond markets and currencies after being battered in 2015.

This would indeed surprise critics of Asia's high credit growth over the past 4 to 5 years; non-financial, private sector credit in Asia ex-Japan had reached about 144% of Gross Domestic Product (GDP) in the 3Q2015, far surpassing the 83% in 1996, just before the advent of the Asian Financial Crisis (AFC). By this measure, critics fear a repeat of the AFC. We view the situation in EM Asia to be far stronger now as the countries' external stability is anchored by high foreign reserves and healthy balance-of-payments. Internal stability, on the other hand, should be maintained with sound banking system, a functioning bond market and stable fiscal position.

With the gradual unwind of the Fed's quantitative easing (QE) and the general economic slowdown, EM credit growth should decelerate. This should bring the debt-to-GDP ratios to a much more moderate level. Such a development could prove financially sustainable for EM Asia which is also backed by other positive fundamentals (refer to Fig.3).

Fig.3.





Source: Top chart – BIS, World Bank, CEIC, Nomura. Note: "Latest" refers to the latest available data as at 24 August 2015: for current account balance Q2 2015 for all countries except Hong Kong, India, Philippines and Korea (Q1). Bottom chart – Haver Analytics, CEIC and Barclays Research, as at August/September 2015.

What's in store for 2016?

In 2016, we feel the Fed can afford to pick up the pace of its tightening, that could bring its funds rate to 1-1.25% by the year-end. Market pricing, as at late October 2015, is anticipating a Fed funds rate of 0.65-0.75%. Our conviction for the steady reduction in labour market slack should cause wage inflation to accelerate, prompting a faster pace of Fed rate normalisation. But even at our projected Fed tightening trajectory, it is still a fairly moderate gradient of rate increases, which the credit and stock markets can absorb albeit with some near term volatility.

We expect credits to offer moderate value given the spread widening in 3Q2015. However, as monetary conditions become less accommodative in the US, credit spreads are unlikely to be compressed markedly while the US dollar will likely be underpinned. The greenback is now at expensive levels given that it has rallied about 17% over the past 2 years. Against EM Asia currencies, where there is some return to "risk-seeking" by investors, and given that Asian currencies are historically at cheaper valuations, we do expect Asian currencies to end 2016 with moderate 2-4% gains versus the US dollar.

Even as we offer a somewhat optimistic view for Asian credits, currencies and local bond markets, we do not want to make light of the global issues. Fragilities remain. The underlying Eurozone and Greek problems have yet to be resolved while the slow wage increases in the developed world could be an indication of these economies lacking vibrancy. We are also cognisant of the limited monetary and fiscal tools available for governments to handle another financial crisis.

We view that current fears have been priced into the financial markets and thus reduces the likelihood of a market crisis. Moreover the US economic and financial rehabilitation are well advanced and a stronger US economic expansion could come in 2016. There are also positive signs of a turnaround in the developed and EM Asia economies.

The 2016 outcome could thus see stock equity and credit markets performing well as investors scale this "wall of worry".

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